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WASHINGTON, DC 20268-0001

Annual Compliance Report, 2013	)	Docket No. ACR2013

REPLY COMMENTS OF THE AMERICAN CATALOG MAILERS ASSOCIATION (ACMA)

(February 14, 2014)

In these Reply Comments, filed pursuant to Commission Order No. 1935 (December 10, 2013), ACMA replies to the Initial Comments of Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. ("Valpak," "VP"), filed January 31, 2014 in the instant docket, and to Valpak's same-day-filed Appendix (and accompanying Excel workbook 'Valpak Multi-year Model_v2013 base.xls').

At 118 pages plus the workbook, Valpak's Initial Comments range widely, providing views on a multitude of matters. Central to it all, however, is a dogged focus (a) on the cost coverage reported for the Standard Flats category (having Commercial and Nonprofit components), which has been designated for reporting purposes as a product, and (b) on the potential usefulness of a profit maximization model Valpak has presented to the Postal Service. More specifically:

- Valpak views the below-100-percent cost coverage for Standard Flats as constituting a subsidy (a) that should be fixed quickly with large rate increases for associated pieces and (b) that "triggered" the Postal Service recently to propose and implement an exigency rate increase, which affected rates applicable to all mail, including Valpak's, undesirably.[1]
- Valpak presents a profit maximization model, apparently to the Postal Service, and argues its usefulness for helping to set rates in the Standard class in a way that would maximize, or at least increase significantly, the contribution from it.

In the following two sections, we discuss these arguments and explain, in short, that the Standard Flats category is not an appropriate one for asking a subsidy question and therefore that the cost coverage of Standard Flats is not properly viewed as suggesting a subsidy, that the cost coverage on Standard Flats cannot be viewed as the cause of the exigency increase, and that Valpak's model is far too limited to be useful.

A. Standard Flats as currently defined is not an appropriate category for asking the subsidy question. Therefore, the cost coverage of it is not properly viewed as suggesting a subsidy. Also, the cost coverage for Standard Flats cannot be viewed as the cause of the exigency increase.

As ACMA explained in its Initial Comments in this docket, the notion of a subsidy (a term used 44 times by Valpak) is defined on the *question* of whether the profits of the organization, here the Postal Service, would increase if the product in question were

[1] "Numerous Underwater Products Continue to Plague the Postal Service, Causing Losses that Triggered an Exigent Rate Increase, …." VP Comments at 43. Valpak's discussion seldom extends beyond Standard Flats, but the "numerous" the Periodicals products (Outside County [which includes Nonprofit and Classroom] and Within County [a preferred category in its entirety]), parcels in First-Class and Parcel Post, Media and Library Mail, and certain International pieces, *Id*. at 44.

withdrawn entirely (i.e., dropped) from the list of products offered to customers and potential customers. While this question is hypothetical, it must be operational, and it comes with two requirements, both logical, both practical, and both reasonable.

a. The first requirement is that the product whose withdrawn is considered must be a sensible product to withdraw—that is, it must be a product that it could be viewed as making sense to withdraw. Otherwise, one is considering an irrelevant alternative. Valpak focuses on a non-sensible withdrawal.

b. The second requirement is that when the effects of withdrawal are assessed, *all* of the effects must be included, i.e., beyond direct effects, all ramifications and all interdependencies associated with withdrawal must be recognized. For the most part, in standard postal parlance, these indirect effects involve cross-elasticities and multiplier effects.[2] None of these have been considered by Valpak. The fact that they might be difficult to quantify is not an excuse for a failure to consider.[3]

Valpak's application runs into serious trouble on these two requirements. The first problem is how to handle the Nonprofit categories. ACMA explained in its Initial Comments that it is not appropriate to include these categories in a subsidy test. To include them anyhow, as Valpak does, is to thwart the provision that Congress made for

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2 It could be argued that cross-elasticities and multiplier effects are usually defined on small changes in rates or volumes, and that the withdrawal of an entire product involves the largest possible downward change in volume. Nevertheless, the notions point to the kinds of things that must be considered.

3 One can imagine (or maybe one can't) a vice president of marketing, being told by the president that the decision to drop product A has caused collateral damage throughout the firm, explaining to the president that he had no data or understanding of what else might happen.

them. The second problem, which ACMA also explained in its Initial Comments, is that Standard Flats is part of a continuum of categories used by Commercial flats mailers, a continuum that includes Standard Flats, Carrier Route, and High-Density. In a step that would cripple the mailers that remain, it simply would not be sensible to withdraw one of these categories and leave the others in place. From a marketing and production perspective, they are a non-reducible unit.

Valpak could respond by reasoning that a defensible course would be to treat the Nonprofits (for subsidy-test purposes) as though they paid Commercial rates, and then to estimate the effects on profits of withdrawing the offering of Standard Flats, Carrier Route, and High-Density, as a group. The problem (for Valpak) is that if this is done, the finding is that the cost coverage is notably above 100 percent, and the *negative* effect on profits of this withdrawal would be even larger than this coverage suggests if the ramifications and interdependencies were considered. That is, if the question is asked properly, the subsidy goes away.

This leaves Valpak with nothing to say except that it disagrees with, or thinks to be unfair, the absolute levels (including the relative levels) of the various rate elements in the schedule of rates presented by the Postal Service to Commercial mailers of non-saturation flats in the Standard class, many of which are catalogs. It is also possible that Valpak disagrees with the Nonprofit rates that Congress has arranged, but it has not addressed this matter with any degree of specificity.

In its Compliance Review of FY 2010, the Commission examined the level of the rates in Standard Flats and found them to be unfairly low. There is no evidence that the Commission considered the Nonprofit rates at that time. Since then, the volume of

Standard Flats has declined significantly, the proportion of Nonprofit has increased (helping to account for the decline in reported cost coverage for Standard Flats),[4] our perspective on the Nonprofit categories has improved, the advent of the FSS has blurred the seperability of Standard Flats, important questions concerning the validity of the costing results have been raised, and the nature of the continuum of rates used by flats mailers has been clarified. More recently, reported coverage has improved and there are sound reasons to expect further improvement. The Commission should now reconsider its conclusion.

Beyond matters associated with these two requirements for subsidy tests, Valpak argues that the below-cost rates of Standard Flats, along with losses from a short list of other products, led to the exigency case.[5] It says that if the Postal Service had used its pricing flexibility in the way advocated by Valpak, the exigency increase would not have been needed. However, pricing flexibility used under a price cap involves both rate increases and rate tempering, tied to a cap allowance. When this is done, volumes, revenues, and costs change, and there is a net effect on profits. The net effect is *much* smaller than the loss receiving attention, and can be negligible, especially if the costs

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4 For the Standard Flats category, the billing determinants show that Nonprofit accounted for 16.7 percent in FY 2010 and 21.8 percent in FY 2013.

5 This suggestion is knitted into Valpak's development. It says, for example: "No exigent rate case would have been necessary if the Postal Service had properly used its pricing flexibility." VP Comments at 8. After discussing underwater products, it says: "The Postal Service's liquidity shortfall is thus seen to be a problem largely of its own making due to pricing." *Id*. *See also* "Putting these losses into context, without the loss from these eight products, the **Postal Service's FY 2013 operating profit** would have been $1.736 billion … or about equal to the additional contribution the Postal Service will earn from the first year of the exigent rate case ($1.78 billion). *Id*. at 43, emphasis in original. "The 4.3 percent across-the-board increase in the exigent case was made necessary, in large part, from losses sustained from underwater products." *Id*. at 48.

are nonresponsive. The path to reaching a net effect is sometimes said to involve "tradeoffs." In its Appendix, Valpak uses the term tradeoff 24 times, and the term appears in the heading of most of the tabs in its workbook. But in the text of its Comments, the notion of a tradeoff is largely neglected, making Valpak's conclusions misleading and wrong. It is simply not the case that the "losses" caused the exigency increase.

B. The Valpak Profit Maximization Model Is Too Limited to Be Useful.

In Docket No. ACR2012, Valpak presented a model that it thought might be useful in selecting rates. In a spreadsheet, the model begins with columns of possible rates, a column for each category. Then at each rate, using demand and cost information, it calculates a *retention fraction*, which is the percentage of an additional dollar of cap authority that is turned into additional contribution. When the columns are aligned so that each row is a fraction-level, each row is also associated with a cap percentage. To maximize contribution, under the bounds and assumptions of the model, one simply selects the row associated with the cap.[6] It is much like a giant slide rule, turned vertical. As the crosshairs are raised, the cap and the contribution increase.

[6] Tied to billing-determinant volumes (period 1), the cap allows a maximum amount of cap space, in dollars, for a class. The ΔP * BaseVolume for a category is the amount of cap space used for that category. From any ΔP position, the *additional* contribution from using an *additional* dollar of cap space for that category, after cost and volume response, can be calculated. Viewed as a proportion of the additional dollar, this additional contribution is the retention fraction. That is, only a fraction of the additional dollar used is turned into additional contribution. If contribution is maximized, the marginal retention fractions for each category should be the same. Otherwise, total-class contribution could be increased by shifting dollars of cap space from one category to another. Valpak begins in period 1 and does all contribution calculations for period 2, after estimating a cost and volume response.

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In Reply Comments in Docket No. ACR2012, ACMA provided a number of observations on the Valpak model. In the instant docket, Valpak presents its model again, with certain enhancements. The model can also be used with constraints, such as that no rates decrease.

Several limitations of Valpak's model are described in the sections below.

1. **The Valpak model does not respect the rates for Nonprofit mailers.** In all six of the categories included in the model, the volume, per-piece revenue, and per-piece cost are each joint for Commercial mail and Nonprofit mail combined (though, it may be noted, the elasticity used is that for Commercial mail, and the same elasticity is used for letters and flats). The effect of this jointness is not inconsequential, as it may be viewed as riding rough shod over what Congress must have had in mind when it arranged the Nonprofit rates.

Congress specified that the Nonprofit rates are to be about 60 percent of the Commercial rates.[7] A charitable interpretation of this requirement would take it to mean

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Valpak states that selecting the optimal rate package "is not a straightforward exercise" (Appendix at 5, Docket No. R2013-11). It is true that if a large number of price possibilities are considered, a large number of lines on a spreadsheet will be required, and that retention fractions will exist on each line. But the calculation of each line is an elementary exercise.

Several questions of construction need to be raised about the Valpak model. First, it may be noted that the model applies the elasticities to percentage changes in volumes and rates in one step from a base position to a candidate position. It would be more consistent with the Postal Service's constant-elasticity demand equations to use a log formulation. Second, the model uses *real* price changes on tab 1 but not on the next six tabs. Third, an error on tab 1 of the workbook should be noted. Column F lines 38-43 calculates a real price change by subtracting the inflation rate from the nominal percentage rate change. This is an improper formula for a real price change.

[7] Formally, it is the average per-piece revenue of Nonprofit mail that is to be 60 percent of the corresponding Commercial figure, and the Postal Service has taken this to apply at the class
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that the Commercial rates would be set at an appropriate level and that the Nonprofit rates would then be set below that level. The Valpak model, however, profit-maximizes the Nonprofit rates. We believe this to be inappropriate. Nonprofit organizations are to be served, as they serve others, not to be milked.

2. **Valpak's principal message about gaining contribution from "underwater" products does not apply.** Much of the use of Valpak's model is to show that, if the model fits and certain assumptions are met (which we argue *infra* are not met), Postal Service finances could be improved substantially if the volume of certain "underwater" products could be driven away by higher rates. This is because, according to the model, each mailpiece driven away would decrease cost more than it would decrease revenue.

In its Initial Comments in Docket No. R2013-11, Valpak acknowledged that ACMA has "explained that catalogers typically use both products [Standard Flats and Carrier Route], and try to enter as much of their mail as possible at the lower Carrier Route rate, with any residual being mailed at the higher Flats rate" (at 39, footnote omitted). Valpak not only did not question ACMA's assertion, but in fact proceeded to use it as a platform for questioning Thress's conclusions about the two categories.

But if it is the case that Standard Flats and Carrier Route are used jointly, and ACMA continues to assert that it is, then the appropriate focus of Valpak's model should

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level instead of at the product level. But if corresponding categories got substantially out of alignment, such as a Nonprofit rate being only a tenth of a cent less than a corresponding Commercial rate, while compliance at the class level was maintained, significant questions would be raised.

be on both categories together, which constitute a category that is not under water, especially if the rates for the Nonprofit mailers are dealt with separately. In other words, the underwater situation, on which Valpak focuses prodigiously, simply does not exist.

3. **Valpak's model does not countenance considerations relating to the Postal Service as a whole.** There is dependence among postal products. Even if the model were focused on appropriate categories, its output would have to be overridden by considerations relating to cross-elasticities, multiplier effects, and interdependencies. Much of this must be judgmental. The Postal Service would be expected to consider such things.

4. **Obtaining meaningful help from Valpak's model depends critically on cost responses that may not occur.** In Docket No. R2013-11, Valpak began a discussion of its model by stating that a "recurring issue in postal pricing is how the Postal Service, when operating under a CPI price cap regime, can maximize contribution to institutional cost" (Appendix at 4). Any cost response, or lack thereof, to a volume change is a critical part of any change in contribution.

In a string of comments over two years, ACMA has raised questions about the validity of the costs being reported, particularly for Standard Flats, but also for Carrier Route and Periodicals (another flats category). Valpak goes on as though no questions have been raised. The questions are serious.

In its Initial Comments in the instant docket, ACMA showed that since 1998, the unit costs of Standard Flats have increased 124.4 percent,[8] after correcting for

[8] In its Comments in Docket No. R2013-10, ACMA presented an additional cost index, labeled an "ALT" index, based on an independently-developed, cost-weighted quantity index.
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increased worksharing, while factor prices have increased only 62.1 percent, and this in the face of regular reports of technological advances.[9] Something is clearly wrong.

One indication is that costs of excess capacity are being attributed, implying that, a decrease in volume would not allow further decreases in costs. When operations are tightened, as they were in FY 2013, the cost coverage will increase. Under these conditions, using Valpak's model now would not lead to improved finances. In other words, Valpak's theory does not fit reality. This makes the model useless.

5. In short, Valpak's model flunks Valpak's own test. Valpak extols the virtue of "[a]ny model that purports to acknowledge the existing reality" (VP Comments at 35) and states that it is "distressing when pricing ignores basic rules of economics" (VP Appendix at 18). But this is precisely the hurdle that Valpak's model cannot jump. Valpak builds a model that does not allow it to deal with reality and is then distressed when reality does not obey the behaviors of that model. It is the responsibility of a model to fit reality, not of reality to fit a model.[10]

Valpak's model (a) does not allow it to deal with the Nonprofit situation—the situation is not even discussed; (b) does not allow it to deal with any policy matters or

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This ALT index shows that, over the 1998-2013 period, the unit costs have increased 140.7 percent. On this basis, we believe the increase of 124.4 percent to be conservative.

[9] Technological changes, that should lower costs, are an ongoing thing at the Postal Service and extend across most or all of its operations. For a listing of the changes made to one particular machine, the AFSM 100, during FYs 2012 and 2013, *see* Response of the Postal Service to Chairman's Information Request No. 4, Question 7, in the instant docket (February 6, 2014), showing 9 changes of significance in two years.

[10] Maslow's law of the instrument is that if the only tool you have is a hammer, then everything looks like a nail. After building a model of some internal beauty, economists often follow this law. Valpak is guilty.

interdependencies or cross-elasticities; (c) does not allow it to acknowledge the interdependence between Standard Flats, Carrier Route, and High-Density, or the fact that Standard Flats is a residual category that is used by small mailers and is declining; and (d) does not allow it to deal with serious questions that have been raised about the validity and the variability of the costs, on which it depends heavily.

ACMA does not contend that these matters are simple or are easy to model. In fact they are complex. The Postal Service should be given the flexibility to deal with them.

Respectfully submitted,

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